Seymour
INVESTMENT MANAGEMENT

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Following a difficult year in 2022, equity markets have generated positive returns in 2023. The first half of 2023 saw technology companies driving the equity returns on both sides of the border with softening energy returns dampening the Canadian S&P TSX Total Return (TSX). S&P TSX Total Return (TSX) saw a modest 1.1% return in Q2 bringing the year to date total return to 5.7%. The TSX underperformed the U.S. S&P 500 Index Total Return (S&P 500) which posted a sizeable 8.7% return over the quarter and 16.9% year to date.

These outsized returns for the S&P 500 were driven almost entirely by a small group of mega-cap technology names.

When examining the composition of the U.S. and Canadian counterpart indices, the S&P 500 and the TSX, one can see the S&P 500's greater prevalence of technology names and healthcare companies. Conversely, the TSX includes a greater weight in energy, materials, and financials. The size and scale of mega-cap companies in the S&P 500 far exceeds the Canadian counterparts, owing to the larger and more diverse U.S. economy. However, the Canadian market holds some unique characteristics and strengths of its own, from world-class companies, which are in some cases under-followed and under-owned, to the prominence of oligopolies in the country (which enjoy less competition and generate attractive returns on capital).

Despite the differences between the U.S. and Canada, over the long-term, historical returns for the TSX and the S&P 500 have been very similar. However, for short and medium stretches of time, the two can vary greatly.

	Year to Date	2 Year	5 Year	10 Year	Compound Annual Since December 31, 1999
S&P/TSX Composite Total Return Index	5.7%	3.0%	7.6%	8.4%	6.5%
S&P 500 Total Return Index (U.S. Dollar)	16.9%	3.4%	12.3%	12.9%	6.8%

The Narrow U.S. Market

The narrowness of the U.S. market is nothing new. The headline grabbing, primarily big-tech names have dominated the S&P500 returns for the past decade. This lack of breadth has become even more apparent recently.

Typically, over the past 25 years, the ten largest stocks of the S&P 500 have made up between 15% - 25% of the index, reflecting the fact that the S&P 500 is a capitalization weighted index and some concentration is expected. Today however, the largest ten stocks represent just shy of 30% of the S&P 500 Index, including Apple, Microsoft, Amazon, Nvidia, Alphabet (Class A and C), Tesla, Facebook, United Health Group, and Berkshire Hathaway.

More than the entire 9.65% total return of the S&P 500 to date in 2023 was generated by the largest eight stocks

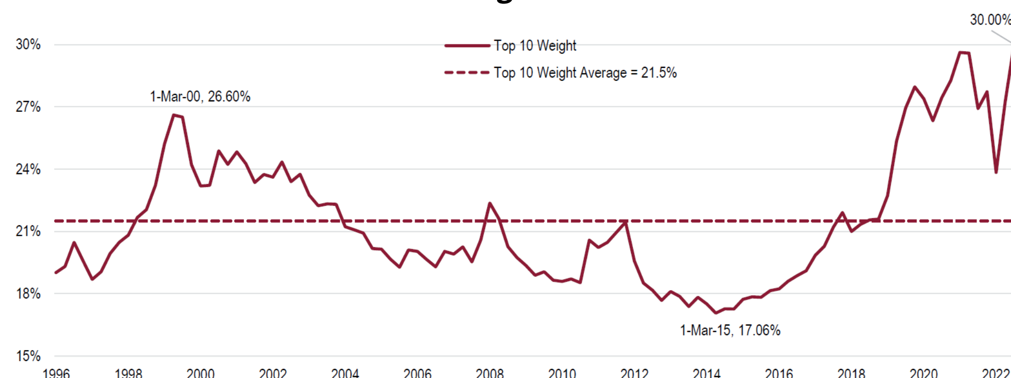
These mega-cap companies have been significant drivers of the S&P 500 returns year to date. Over the first five months of 2023, the largest eight stocks accounted for more than the entire 9.65% total return of the S&P 500. Without these eight stocks, the S&P 500 would have been down slightly over the same time period. If the pool of companies is expanded to the entire 3,480 in the U.S. stock market measured by the FT Wilshire 5000 Index, these 8 stocks still represent 98% of the year's return for the entire index.

Similarly in Canada, Shopify contributed 320 points to the TSX return, approximately 40% of the total year to date gain, with the Information Technology sector contributing to 66% of the TSX year to date returns.

Although a relatively narrow S&P 500 is typical due to its structure allocating greater share to large and growing companies (as opposed to an equal weight index for instance), this lack of breadth has become even more apparent as of late. As demonstrated in the chart below, concentration has reached levels not hit since March of 2000.

The largest ten stocks represent approximately 30% of the S&P 500 Index

Exhibit 1: Concentration of the Largest 10 Securities as a Percent of the S&P 500 Index



Source: Bloomberg, FactSet, CIBC World Markets Inc.

At the height of Internet craze of 2000, the largest five stocks – Microsoft, Cisco, Exxon Mobil, Intel, and GE - accounted for 18% of the index. Goldman Sachs points out that just five years later, these same five companies made up 12% of the index; 20 years later these once serious heavy-weights made up 8% of the index. Of these names, only Microsoft and Exxon Mobil have managed to repeat their lofty top-ten status since 2000.

Valuation of U.S. and Canadian Markets

As a result of the year to date movement, these mega-cap technology names in the U.S. are 50% more expensive than their long-term average. These are contributing significantly to driving up the valuation of the U.S. market as a whole.

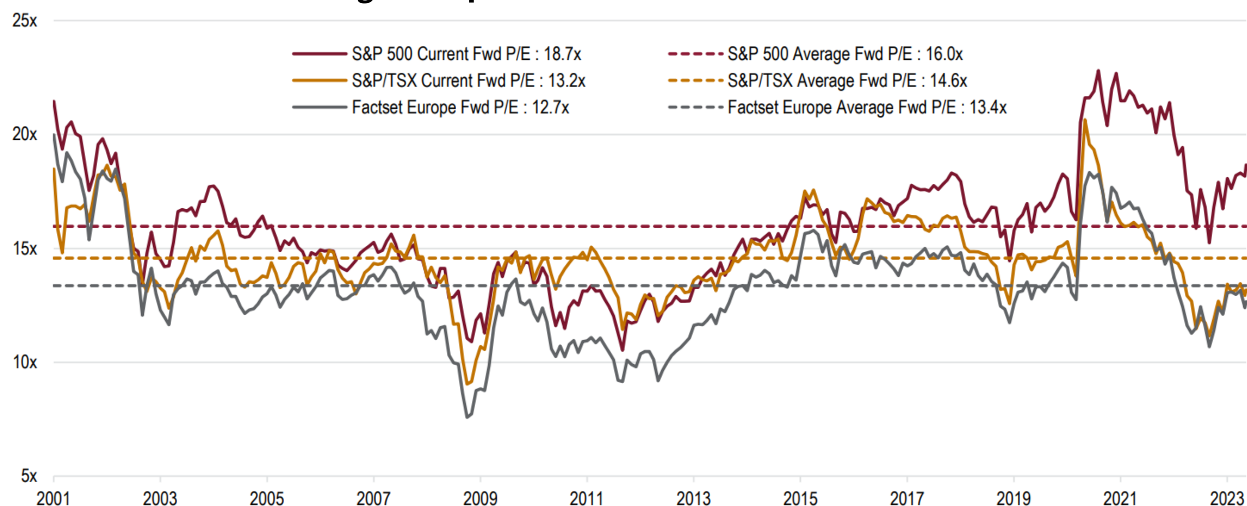
Exhibit 2: Forward Price to Earnings Valuation of Largest Ten Securities of the S&P 500

Company Name	Forward P/E
APPLE INC.	28.2X
MICROSOFT CORPORATION	29.8X
AMAZON.COM, INC.	60.4X
NVIDIA CORPORATION	46.7X
ALPHABET INC. CLASS C	21.1X
ALPHABET INC. CLASS A	20.9X
TESLA INC	61.1X
FACEBOOK, INC. CLASS A	20.3X
UNITEDHEALTH GROUP INCORPORATED	18.7X
BERKSHIRE HATHAWAY INC. CLASS B	20.5X
Total (Weighted Average for P/E and Performance)	29.2X
S&P 500	18.7X

Source: Bloomberg, CIBC World Markets Inc.

As demonstrated by the price/earnings chart below, the U.S. market, represented by the S&P 500, currently trades approximately 15% above its long-term average. In comparison, the Canadian market, represented by the TSX, trades approximately 10% below its long-term average.

Exhibit 3: Price to Earnings Multiples from 2001 to 2023



Source: FactSet, CIBC World Markets Inc.

When one removes the top ten largest stocks from the S&P 500, the remaining 490 stocks sit roughly in line with their long-term valuation levels. Removing Shopify from the TSX, the index sits even further beneath its long-term valuation levels. There is even more value in the small and mid-cap space of the TSX, as many companies sit significantly below their long-term valuation levels, pricing in a material expectation of a mild recession.

This divergence exemplifies the ebb and flow of relative ‘expensive’ and ‘cheap’ companies and markets. Although the smaller 490 companies of the S&P 500 have outperformed the top ten over the past 20 years, over the past five years they have underperformed by a spread of nearly 5.5% per year. Similarly, despite the S&P 500 outperforming its Canadian counterpart for the past decade (by 4.5% per year), over the past 23 years both indices have had almost equal returns. Such convergence of returns over time suggests that the TSX may outperform the S&P 500 over the coming years.

During times of uncertainty or market turbulence, investors tend to focus on large-cap companies. Fund flows into small and mid-cap stocks decline precipitously, resulting in periods of extreme underperformance, as we’ve seen recently. The flow presents an opportunity for active investors with a long-term time horizon.

Buying small and mid-cap stocks when valuations are deeply depressed (which they are now in many cases) has historically led to outsized returns as a result of both higher earnings growth over a full cycle and valuation re-rates.

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Market downturns present opportunities for active investors that can be patient, avoid the pitfalls of emotional investing, and have a long-term time horizon. Historically, small and mid-cap stocks underperform in declining markets. However, as markets recover, they offer the most significant appreciation potential. While currently out of favour, these small and mid-cap companies continue to operate with strong balance sheets and sustainable earnings generation.

Sincerely,
The Seymour Team